The Islamic Financial System

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GROWING SIGNIFICANCE OF THE ISLAMIC FINANCIAL SYSTEM

The Islamic financial system has evolved into a viable and vibrant component of the overall financial system, complementing the conventional financial system. The Financial Sector Masterplan (FSMP) provides clear strategic focus to develop and promote the expansion of the Islamic banking system. Against the backdrop of a stronger economy and strong macroeconomic fundamentals, Islamic banking activity experienced rapid growth to account for 9.7% of the total assets of the banking system in 2003 from 6.9% in 2000. The market share of deposits and financing also increased markedly to account for 10.4% (2000: 7.4%) and 10.3% (2000: 5.3%) of the total banking system respectively. The rapid progress of the domestic Islamic banking system, accentuated by significant expansion and developments in Islamic banking and finance has become increasingly more important in meeting the changing requirements of the new economy.

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In Malaysia's dual banking environment, the Islamic financial system operates in parallel with the conventional financial system. The Islamic financial system encompasses the Islamic banking system, Islamic money market, Islamic insurance or takaful, Islamic capital market and the specialised financial institutions which provide alternative sources of financing. The intra-dependency of these key structural components creates a comprehensive enabling environment for the Islamic financial system to effectively play its role as an efficient conduit to mobilise resources and provide financing for productive economic activity. This structure also enhances the resilience and robustness of the Islamic financial system to withstand financial shocks and contributes to the overall stability of the Islamic financial system.

- The Islamic banking system which forms the backbone of the Islamic financial system plays an important role in mobilising deposits and providing financing to facilitate growth. The Islamic banking system is currently represented by 33 Islamic banking institutions, comprising two Islamic banks and 31 conventional banking institutions (nine commercial banks, four foreign banks, seven finance companies, four merchant banks and seven discount houses) offering Islamic banking products and services under the Islamic Banking Scheme. These Islamic banking institutions offer a comprehensive and broad range of Islamic financial products and services ranging from savings, current and investment deposit products to financing products such as property financing, working capital financing, project financing, plant and machinery financing, hire purchase, education financing and other financing products including trade finance products. The ability of the Islamic banking institutions to arrange and offer products with attractive and innovative features at prices that are competitive with conventional banking products, has appealed to both Muslim and non-Muslim customers, reflecting the capacity of the Islamic banking system as an effective means of financial intermediation. The extensive distribution network of Islamic banking institutions, comprising 152 full-fledged Islamic banking branches and 2,065 Islamic banking counters (offering Islamic banking products), that is also well supported by an efficient, secure and effective payment system, has enhanced access to banking services for the various sectors of the economy.

- The existence of an active Islamic interbank money market is another important component in the Islamic financial system. Under the *mudharabah* (profit-sharing) interbank investment (MII) mechanism, Islamic banking institutions are able to raise funds to meet their short-term funding requirement based on profit-sharing arrangement. Since its inception in 1994, the volume of MII increased from only

Table 5.1
Islamic Banking System: Key Data

	As at end		Annual change (%)
	2002	2003*p*	2003*p*
Number of financial institutions	**35**	**33**	**-5.7**
Commercial banks	14	13	-7.1
Finance companies	9	7	-22.2
Merchant banks	3	4	33.3
Islamic banks	2	2	0.0
Discount houses	7	7	0.0
Total assets (RM million)	**68,070**	**82,196**	**20.8**
Commercial banks	29,109	36,824	26.5
Finance companies	12,623	17,875	41.6
Merchant banks	1,430	1,716	20.0
Islamic banks	20,160	20,955	3.9
Discount houses	4,748	4,826	1.6
Total deposits (RM million)	**53,306**	**60,212**	**13.0**
Commercial banks	23,476	26,519	13.0
Finance companies	9,094	10,965	20.6
Merchant banks	684	852	24.6
Islamic banks	16,421	17,584	7.1
Discount houses	3,631	4,292	18.2
Total financing (RM million)	**36,718**	**48,615**	**32.4**
Commercial banks	16,706	22,324	33.6
Finance companies	10,050	15,746	56.7
Merchant banks	804	781	-2.9
Islamic banks	9,158	9,764	6.6
Discount houses	n.a.	n.a.	n.a.
Financing-deposits ratio (%)	**68.9**	**80.7**	**11.8**
Commercial banks	71.2	84.2	13.0
Finance companies	110.5	143.6	33.1
Merchant banks	117.5	91.7	-25.8
Islamic banks	55.8	55.5	-0.3
Discount houses	n.a.	n.a.	n.a.
Number of branches	**138**	**152**	**10.1**
Commercial banks	8	13	62.5
Finance companies	2	7	250.0
Islamic banks	128	132	3.1
Number of counters	**2,065**	**2,065**	**0.0**
Commercial banks	1,335	1,410	5.6
Finance companies	730	646	-11.5
Merchant banks	–	9	–

n.a. Not applicable.
p Preliminary

RM0.5 billion in 1994 to RM283.8 billion in 2003. The availability of a broad spectrum of short and long-term Islamic financial instruments such as Government Investment Issues (GII), Bank Negara Negotiable Notes (BNNN) and Islamic private debt securities as well as the active trading of these instruments allow Islamic banking institutions to meet their investment and liquidity needs. The GII and BNNN are also among the instruments used by Bank Negara Malaysia to manage liquidity in the Islamic banking system. The efficiency of the Islamic money market is enhanced by the Real-Time Gross Settlement System (RENTAS) and the Fully Automated System for Tendering (FAST). RENTAS facilitates larger value interbank funds transfers and scripless securities while FAST facilitates the tendering process for Islamic securities including government securities, commercial papers and private debt securities.

- In the Islamic capital market, funds are raised to finance long-term infrastructure and development projects through the issuance of Islamic private debt securities. The Islamic capital market reduces over-dependence on the Islamic banking system for long-term financing and allows Islamic banking institutions to diversify part of the risks emanating from asset and liability mismatches. The existence of the Islamic capital market plays an important role in reducing potential source of financial vulnerabilities and contributes to enhance the robustness and resilience of the Islamic financial system, leading to greater financial stability. The issuance of diverse Islamic financial instruments ranging from short-term Commercial Papers and Medium Term Notes to long-term Islamic bonds facilitates Islamic banking institutions in meeting their investment and liquidity needs. The different financial structures of the Islamic instruments also provide flexibility to issuers in managing their distinct financing requirements. Moreover, the Islamic financial instruments attract a wider investor base, encompassing both Islamic and conventional institutional investors, and thereby the funds raised can be tapped at competitive cost. In addition, the active participation of Islamic banking institutions in deal origination, underwriting and corporate advisory services expands the breadth and depth of the Islamic capital market, contributing to increased effectiveness and efficiency of the Islamic financial system.

The availability of credit ratings by the external credit rating agencies such as the Rating Agency Malaysia (RAM) and Malaysian Rating Corporation Berhad (MARC) enhance price discovery and efficiency of the market and facilitate efficient investment and financing decisions. The efficiency of the Islamic debt securities market is further augmented by settlement and tendering systems such as RENTAS and FAST as well as the Bonds Information Dissemination System that provides comprehensive market information on domestic debt securities.

- In the Islamic equity market, Islamic institutional investors participate in capital raising exercise to finance business expansion of corporations. The Islamic unit trusts provide investors access to professional management of funds to maximise returns on different risk profiles. The comprehensiveness of the Islamic financial system creates significant investment opportunities for both Islamic and conventional investors in managing their portfolios to meet financial needs.

- The takaful industry adds significant synergies to the overall Islamic financial system. Takaful operators, particularly in general takaful business, contribute to mitigate part of the risks of the banking system emanating from financing transactions and hence strengthen the resilience of the Islamic financial system. In the family takaful business, takaful operators assume an important role as economic agents that mobilise long-term savings for long-term investments and economic growth. The role of takaful operators as institutional investors has contributed to stimulate the development of Islamic financial instruments and consequently adds depth to the Islamic financial markets.

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- Specialised non-bank institutions offering Islamic financial products and services such as the development financial institutions (DFIs) and Pilgrims Fund Board complement the Islamic banking system in expanding its reach to specific strategic economic sectors thereby enhancing the capacity of the Islamic financial system in its overall contribution to economic growth and development. Meanwhile, the existence of ancillary institutions such as the National Mortgage Corporation (Cagamas Berhad) contributes to enhance resilience of the Islamic financial system through securitisation of the Islamic house financing and Islamic hire purchase receivables in the portfolios of Islamic banking institutions.

Ensuring Financial Soundness and Stability

The Islamic financial system operates under a robust and comprehensive legal, regulatory, supervisory and Shariah framework. The Islamic banks are regulated and supervised by Bank Negara Malaysia under the Islamic Banking Act 1983 (IBA), while the conventional banks participating in the Islamic Banking Scheme (IBS banks) are regulated under the Banking and Financial Institutions Act 1989 (BAFIA). Islamic banking institutions operate under a robust regulatory and supervisory framework based on international standards and best practices, at par with conventional banking institutions. For the IBS banks, the robustness of the regulatory and supervisory framework includes the establishment of effective firewalls to ensure that there is complete segregation between Islamic banking and conventional banking portfolios in line with the dictates of the Shariah. This is to preserve the integrity and confidence in the Islamic banking system.

- Islamic banks observe the Basel Capital Accord in maintaining a minimum risk-weighted capital ratio (RWCR) of 8% and a minimum core capital ratio of 4%. The IBS banks observe the compliance to the RWCR framework for the Islamic banking portfolio in addition to the compliance on a consolidated basis (for both Islamic banking and conventional banking portfolios).

- To ensure Islamic banks maintain sufficient liquidity at all times, Islamic banks are required to observe the liquidity framework. Under this framework, Islamic banks are required to manage their liquidity positions in a dynamic manner through the matching of short-term liquidity requirements arising from maturing obligations with maturing assets. In addition, Islamic banks are required to maintain adequate liquidity surpluses to be able to sustain unexpected heavy withdrawals for at least one month. In the case of the IBS banks, this liquidity framework is observed on a consolidated basis.

- Prudent management of the Islamic banking portfolio is pertinent to protect the interest of depositors in view of the profit and loss sharing nature of Islamic banking operations. To inculcate prudent financing practices, Islamic banking institutions are required to provide adequate

provisioning for potential deterioration in asset quality and observe the credit limit to a single customer and its related corporations.

- Islamic banking institutions observe the Central Bank's guidelines on best practices in credit risk management and prohibition of financing to directors, staff and their interested corporations to prevent abuses, conflicts of interests and irregular practices.

- Strong corporate governance is essential to ensure that Islamic banking institutions are managed by competent management who are able to provide the strategic direction for the institution as well as manage the operations of Islamic banking institutions in an effective and prudent manner. Islamic banks adhere to the Central Bank's guidelines on corporate governance pertaining to the appointment of directors, the structure of the board, limitation on the number of directorships of directors and chief executive officers, code of conduct for directors and employees of banking institutions as well as guidelines on minimum audit standards. To further strengthen the corporate governance structure of Islamic banks, additional measures were introduced in 2003 requiring Islamic banks to establish a nominating committee, remuneration committee and risk management committee to ensure that the shareholders play a more active role in overseeing the effectiveness of the board of directors and management. The guidelines highlighted the roles and responsibilities of independent directors, which include *inter alia*, to provide effective oversight and enhance the independence of the board. The guidelines also specified the minimum qualifications and training requirements for directors.

- In the preparation of financial statements, Islamic banks are required to observe the Guidelines on the Specimen Reports and Financial Statements for Licensed Islamic Banks (GP8-i). The IBS banks disclose their Islamic banking operations in the Notes to the Accounts of the principal financial statements as part of GP8 of the conventional banks. To further enhance transparency in the derivation of the rate of return in Islamic banking business, Islamic banking institutions are required to observe a standard framework for the calculation of the rate of return.

- Another important dimension in Islamic banking operations is Shariah compliance. Under the IBA, Islamic banks need to establish Shariah advisory bodies. Central to these bodies is the Shariah Advisory Council (SAC) at Bank Negara Malaysia as the sole authority to decide on Shariah matters on Islamic banking and financial business that fall under the purview of the Central Bank. The SAC at Bank Negara Malaysia also serves as the ultimate reference for Shariah ruling in court proceedings on Islamic banking and finance cases.

- The Anti-Money Laundering Act 2001 (AMLA) and guidelines on money laundering and "know your customer policy" protect the Islamic banking system from money laundering activities. AMLA provides comprehensive laws for the prevention, detection and prosecution of money laundering, the forfeiture of property derived from, or involvement in money laundering and the requirements for record keeping and reporting of suspicious transactions by Islamic banking institutions.

- To reinforce the regulatory framework that has been established to preserve financial stability, Islamic banking institutions are subject to a rigorous supervisory framework. Supervisory activities emphasise the vigilant monitoring of the financial condition and soundness of Islamic banking institutions, the adoption of pre-emptive strategies to address any adverse trend or weakness identified and the instilling of best practices to enhance corporate governance structures as well as risk management systems. The supervisory process is premised on a forward-looking proactive risk-based model encompassing both dynamic off-site surveillance and on-site examinations. The off-site surveillance process includes the review and approval of financial statements to ascertain compliance with Bank Negara Malaysia's guidelines as well as close monitoring of Islamic banking institutions through regular reporting and rigorous financial and non-financial analysis for early detection of any emerging problems. In 2003, on-site examinations were conducted on the Islamic banks, comprising the head offices, local and offshore branches, based on the CAMELS rating framework. In addition, stress testing remains an on-going exercise where the Islamic banking institution's current financial condition is subjected to simulated stress under alternative

adverse scenarios in order to detect potential areas of vulnerability. The results of this stress test form the basis for the implementation of pre-emptive actions.

Global Integration of Islamic Financial System

The significant progress achieved by the domestic Islamic financial system has set the stage for its integration with the global market place. The initiatives on the global front to position the Islamic financial system as a credible component of the global financial system will contribute to further strengthen the development of the domestic Islamic financial system.

- The establishment of the Islamic Financial Services Board (IFSB) in Kuala Lumpur to develop international prudential regulatory standards in accordance with the distinct features and risks of Islamic financial institutions will contribute towards ensuring the soundness and stability of the Islamic financial system. Since its establishment in 2002, the IFSB has attracted wide participation. As at end-2003, the number of IFSB members has increased to 13 full members, three associate members and 20 observer members. The IFSB has made progress in developing prudential standards on capital adequacy and risk management and will commence preparation of an additional standard on corporate governance. The participation of the International Monetary Fund, the World Bank, the Asian Development Bank and the Bank for International Settlements in the IFSB will enhance co-operation towards achieving the common goal of international monetary and financial stability.

- The establishment of the International Islamic Financial Market (IIFM) in 2002 constitutes part of the overall efforts to strengthen the efficacy of the Islamic financial system as a component of the global financial system in achieving balanced growth and development. The IIFM provides the infrastructure to facilitate the mobilisation of foreign capital according to Shariah principles, stimulate the creation and trading of Islamic financial instruments, enhance investment opportunities for global investors and facilitate efficient liquidity management by Islamic financial institutions. Malaysia spearheaded the issuance of the first sovereign global Islamic *sukuk* to give impetus to the development of the IIFM. The global Islamic bond served as a benchmark and catalyst that spurred the issuance of subsequent global Islamic bonds. The development of Islamic finance as an important niche activity in Malaysia's International Offshore Financial Centre in Labuan complements the development of the IIFM in the issuance, listing and trading of foreign currency-denominated Islamic financial instruments as well as in forging linkages with other Islamic financial centres to further expand the global reach of Islamic banking and finance.

POLICY THRUST IN 2003

In tandem with the overall objective of the FSMP to create an efficient, progressive and comprehensive Islamic financial system that can contribute significantly to the effectiveness and efficiency of the Malaysian financial sector, the Islamic financial policy thrust in 2003 continued to be directed at further strengthening the fundamental underpinning foundations of the Islamic banking system to support the development of a sound and progressive Islamic banking industry. The focus was on strengthening the institutional financial infrastructure, enhancing the regulatory framework, strengthening the Shariah and legal infrastructure as well as enhancing intellectual capital development and consumer education.

The Islamic financial policy thrust in 2003 continued to be directed at further strengthening the fundamental underpinning foundations of the Islamic banking system to support the sound and progressive development of the Islamic banking industry.

Strengthening Institutional Financial Infrastructure

Institutional Development

A comprehensive and well-developed financial infrastructure is key to enhancing the capacity and effectiveness of the Islamic banking system premised on its own principles, uniqueness and characteristics.

- One feature of a well-developed financial infrastructure is the diversity of the players, including the participation of foreign players in the Islamic financial landscape. Cognisant of this,

Bank Negara Malaysia has brought forward the liberalisation of the Islamic banking sector. The presence of full-fledged foreign Islamic banks in Malaysia will generate spill over effects that will enhance product diversity, spur financial innovation and support the overall development of the Islamic financial system. It will also act as a bridge between Malaysia and other global Islamic financial markets, thus providing the enabling environment for Malaysia to become a regional hub for Islamic banking and finance.

- As the domestic Islamic banking industry progresses into a more advanced stage of development, significant developments are shaping the industry's financial regulatory infrastructure, both on the domestic and international fronts.
  - On the domestic front, these included the emergence of a different set of accounting standards for Islamic financial business to be issued by the Malaysian Accounting Standards Board (MASB) and the introduction of the Deposit Insurance Scheme.
  - On the international front, the Islamic Financial Services Board (IFSB) will be issuing a specific set of prudential regulatory and supervisory standards to govern Islamic banking operations globally.
- Against this backdrop, Bank Negara Malaysia has conducted a review of the existing "window" institutional structure of the IBS banks to prepare an enabling structure that can assimilate these developments and thus strengthen the prudential regulatory and supervisory regime.

Risk Management

The enhancement of risk management capabilities of the Islamic banking institutions is another important aspect in developing the institutional financial infrastructure.

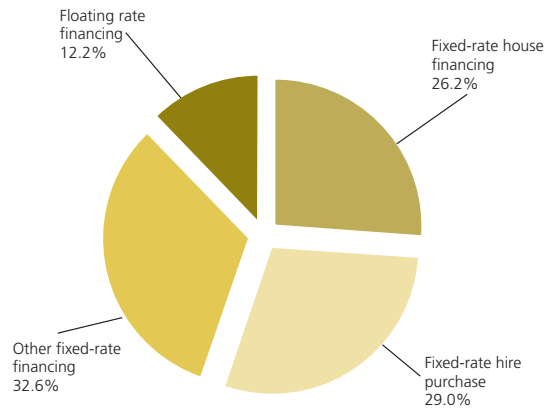
- A variable rate financing product under the concept of *bai' bithaman ajil* (deferred payment sale) was introduced in 2003 as an instrument to diversify the financing portfolio of the Islamic financial institutions from over-reliance on fixed-rate financing as well as to mitigate the risk associated with funding mismatch.
- Moving forward, to complement the *bai' bithaman ajil* (BBA) floating rate financing

Introduction of Islamic Variable Rate Mechanism

A significant achievement was made in 2003 in the area of risk management when the first variable rate financing product was developed for the Islamic banking industry under the concept of *bai' bithaman ajil* (deferred payment sale), or in short, BBA. This Shariah-compliant product was structured by a working group comprising representatives from Bank Negara Malaysia and the industry to enable the Islamic financial institutions which operate in a dual banking environment to constantly match the current market financing rate in order to provide matching returns to their depositors, thereby alleviating any mismatch risk. By doing this, the Islamic financial institutions are able to receive varying income streams from their financing activities, which will be distributed to the depositors at a more competitive rate.

The new instrument is an alternative to the existing mode of financing portfolio which is predominantly fixed-rate in nature. In recent developments, the high leverage on fixed-rate financing became a topical issue in Islamic banking as there has been an inadequate hedging mechanism through which Islamic financial assets could grow and be protected from exposure to fluctuations in the financing rate. As at end-December 2003, total fixed-rate financing accounted for 87.8% of total Islamic financing and a large proportion of this financing, namely, house and other property financing-i and term financing-i, were predominantly on a longer term tenure, constituting 58.8% of total Islamic financing, as shown in Graph 1. (The current method of variable rate financing offered by a few Islamic financial institutions is impractical as it involves multiple sub-agreements to reflect a change in the rate).

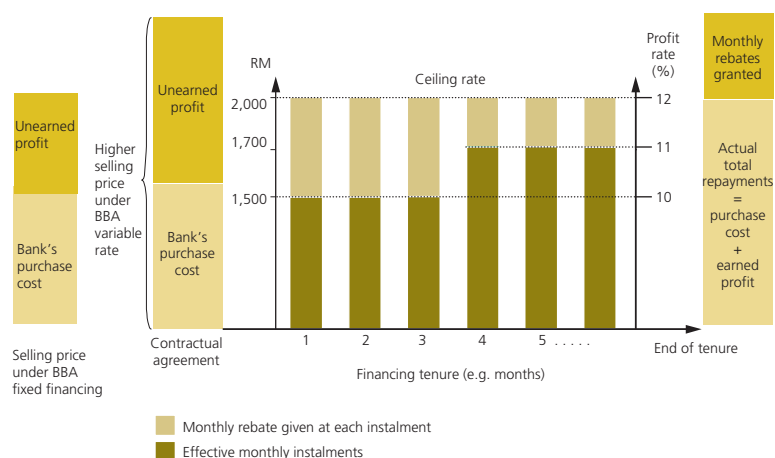
This fixed-rate regime has resulted in a funding mismatch to the Islamic financial institutions because their long-term financing was funded by short-term bank deposits which can give variable returns. As

Graph 1
Total Financing by Mode of Financing as at end-2003

the banks had locked in their profit rates for the financing over a long period, any upward movement in the market rates, therefore, may result in the Islamic banking institutions finding it difficult to give a satisfactory return to their depositors. This is because the constant income stream from the financing is tied to a fixed profit rate which is relatively lower when compared to a conventional floating rate loan whose rate has risen. Inevitably, this situation would cause a switching of Islamic funds to conventional funds.

The variable rate financing is designed to mitigate the mismatch risk currently faced by the Islamic financial institutions by allowing them to vary the profit rate for the financing in order to raise the deposit rates. As a result, the depositors will obtain satisfactory returns vis-à-vis that in the conventional banking market, and hence, would not switch their deposits which otherwise could adversely affect the Islamic banking operation. This new option reduces the vulnerabilities of the Islamic financial institutions to exposure in market risk in a banking environment where the Islamic banking system and conventional banking system operate side-by-side.

The variable rate financing is an innovation to the existing BBA financing concept which is fixed-rate in nature. Under the BBA, the selling price of the asset sold to the customer on deferred terms would be fixed at a profit rate known as the ceiling profit rate which is higher than the profit rate under the fixed-rate BBA financing where, in principle, the contractual selling price and instalments would be higher. However, rebate known as *ibra'* (a waiver of right to claim unearned profit) is required to be granted at every instalment, for example on a monthly basis, in order to reduce the monthly instalments to match that of the current market level.

As illustrated in Graph 2, the financing is created upon the bank purchasing the asset from the customer for cash which will be immediately sold back on deferred terms. Computed at a ceiling rate of 12% per annum as in the example, the selling price (which is higher than under BBA fixed financing) will be agreed upon and the contractual repayment is to be made in equal monthly instalments of RM2,000 over the agreed period. If the base lending rate (BLR) plus margin used as benchmark in the pricing calculation is 10% per annum for the first month, the bank would give a monthly rebate of RM500, which represents the difference between the ceiling profit rate of 12% per annum and effective profit rate of 10% per annum. If in the fourth month, the market rate rises to 11% per annum, the bank would then only grant a monthly rebate of RM300.

Graph 2
BBA Variable Rate Financing

In practice, the rebate would be varied so that the effective profit rate (ceiling profit rate less rebate) reflects the fluctuating market financing rate. Accordingly, the bank would be able to raise the financing rate when there is a rise in market rate, hence, it can give better returns to its depositors. As such, this justifies the setting of a high ceiling profit rate to buffer any rise in the market rate. However, if the market rate rises beyond 12% per annum, the effective profit rate would remain at the ceiling rate. The ceiling rate would provide some comfort to the customer that the effective profit rate would be capped at that rate.

To govern this mode of financing, such rates are subject to a ceiling profit rate of four percentage point above the market's BLR unless supported by findings that the market rate is forecasted to be volatile and escalating. In setting the effective profit rate, the banks are required to observe the maximum profit spread of 2.5 percentage point above the BLR. However, as a matter of policy, the effective profit rate cannot transgress the ceiling profit rate even if the market rate rises above the latter, while any change to the effective profit rate would need to be communicated to the customer prior to the change.

At maturity, any difference in the amount between the selling price and the total repayments plus the monthly rebates granted, would be rebated. In addition to the rebates on instalments and at maturity which have been made mandatory to be included in the financing agreement, rebates must also be granted in the event of early settlement or redemption, or termination of contract. Bank Negara Malaysia has allowed rescheduling of the financing (where the period of financing can be extended) if the bank wishes to grant the option that the effective monthly instalment need not be increased if the effective profit rate rises, on the condition that the financing agreement contains a rescheduling clause and the total repayments are not in excess of the original selling price. The computation of capital adequacy for the BBA variable rate financing will be accorded the same risk-weight as under the BBA fixed-rate financing.

Currently, this new mode of financing is applicable to house, property and term financing only and would be extended to other types of financing in due course. Undoubtedly, this new product is expected to grow significantly as it is a natural hedging product, particularly in view of the risk exposure issues prevalent in Islamic banking today.

mechanism, another variable rate financing product based on the concept of *ijarah muntahia bittamleek* (leasing ending with ownership) is being explored.

Enhancing Regulatory Framework

The growing significance of the Islamic banking industry requires the development of an effective regulatory framework to provide the enabling environment to support the development of the industry.

- In 2003, Bank Negara Malaysia conducted a review on the Framework of the Rate of Return. The purpose was to further strengthen the methodology for deriving the rate of return to depositors, whereby the revised framework is to provide a greater degree of flexibility in the implementation of the framework.

- The Guidelines on the Specimen Reports and Financial Statements for Licensed Islamic Banks (GP8-i) was issued in August 2003. The objective was to promote consistency and standardisation amongst the Islamic banks in complying with the provisions of the IBA and approved accounting standards, specifically MASB *i*-1 and the Shariah requirements. The Guidelines prescribed the minimum requirements of the financial statements that the Islamic banks need to disclose.

- In the development of accounting standards for Islamic financial business, the Malaysian Accounting Standards Board has embarked on the preparation of standards on leasing *(ijarah)*, deferred payment sale (BBA) and cost-plus *(murabahah)* in relation to the recognition, measurement and disclosure of these Islamic financial transactions.

The Framework of the Rate of Return

Towards standardising the methodology on the calculation of distributable profits and the derivation of the rates of return to depositors in Islamic banks, Bank Negara Malaysia introduced the "Framework of the Rate of Return". Among others, the objectives of the framework are to: -

(i) Set the minimum standard in calculating the rates of return;
(ii) Level the playing field and provide the terms of reference for the Islamic banking institutions (IBIs) in deriving the rates of return; and
(iii) Provide Bank Negara Malaysia with an effective yardstick to assess the level of efficiency of the IBIs.

Prior to the introduction of the framework, the IBIs adopted various methods in deriving the rates of return. Such practice has led to large variations in the results and implications. For example, some IBIs include all types of income in their computation while some exclude certain type of incomes. These variations have led to the following impediments in terms of: -

(i) Assessment of the rates of return by Bank Negara Malaysia specifically to ascertain whether the rates genuinely reflect the true performance of the IBIs or otherwise;
(ii) Regulation and supervision by Bank Negara Malaysia, particularly in assessing the prudence and fairness in the distribution of profits to the depositors; and
(iii) Assessment by the IBIs of their funding cost, which in turn led to the distortion of rates of return in the retail and inter-bank markets.

The standardisation of the rates of return was also aimed at addressing the information asymmetry between the IBIs and the depositors by enhancing the level of transparency and ensuring that depositors would receive fair returns on their investment. The framework would detail the items, for example, the income and expense items that need to be reported and incorporated for the purpose of the calculation. In particular, the calculation table lists the expense items that need to be shared by the depositors and the bank; and items that are to be solely borne by the bank.

The introduction of the framework is also to effectively support the application of *mudharabah* (profit-sharing) contract in Islamic banking deposit-taking activities. Unlike conventional banking, which is

based on a lender-borrower relationship, the *mudharabah* contract is based on an investor-entrepreneur relationship. In this system, the depositor assumes the role of capital provider while the bank assumes the role of the entrepreneur. The depositors' funds are utilised for financing and investment activities, and the profits generated from these activities are shared between the depositor and the bank based on the pre-agreed profit sharing ratio. In the event of a loss, it will be borne by the depositors. As the bulk of the deposits in Islamic banking are in the form of *mudharabah* deposits, it places a higher degree of fiduciary risk on the management of the IBIs to ensure that the funds are utilised in the most efficient manner, as profits generated from the financing and investments are distributed to the depositors in the most equitable manner. Towards this end, the framework was introduced, not only to standardise the methodology for the calculation of returns, but also to ascertain the actual and fair distribution of income to the depositors.

The Framework

The Framework of the Rate of Return comprises two main components, that is, the calculation and distribution tables. The **calculation table** prescribes the income and expense items that need to be reported and sets out the standard calculation in deriving the net distributable income. Among the important items in the calculation table is the provisions. Prior to the issuance of the framework, the provisions of the banking institutions participating in the Islamic Banking Scheme (IBS banks) were provided by the conventional banking operations. Under conventional banking operations, the provisions are solely borne by the bank. However, under the framework, the IBS banks are required to distinguish their general and specific provisions, in accordance with the *mudharabah* contract, whereby the provisions in Islamic banking operations are shared by both the depositors and the bank.

Table 1
Calculation Table

	RM million
Income generated from asset items	
(+) Net trading income	
(+) Other income	
Total gross income	
(-) Provisions and income-in-suspense	
(-) Profit equalisation reserve	
(-) Direct expenses	
Net gross income	
(-) Income attributable to:	
Specific investment account	
IBCF/SHF[1]	
Net income	
(-) Income attributable to:	
Amount due to designated FIs	
Islamic negotiable instruments	
Net distributable income	

[1] Islamic banking capital funds/ shareholders' funds.

The calculation table also introduced a new item known as **Profit Equalisation Reserve (PER)**. The PER is an item that acts as a mechanism to mitigate the fluctuation of rates of return arising from the flux in income, provisioning and total deposits. This would ensure that the rates of return of the IBIs remained competitive and stable. The PER is appropriated out of the total gross income and is shared by both the depositors and the bank.

The second component of the framework is the **distribution table**. The table sets out the distribution of the net distributable income, derived from the calculation table among demand, savings and general investment deposits according to their structures (*mudharabah* or non-

Table 2
Distribution Table

Type of deposit	ADA[1]	Weightage	WADA[2]	Distributable profits		Depositors' portion		
				RM	%	PSR[3]	RM	%
Current account								
Savings account								
GIA[4]								
1-month								
3-month								
6-month								
9-month								
12-month								
Above 12-month								
				NDI[5]				

[1] Average daily amount of each type of deposit.
[2] Weighted average daily amount.
[3] Profit sharing ratio agreed by the bank and depositors.
[4] General investment account.
[5] Net distributable income transferred from Calculation Table.

mudharabah), maturities and the pre-agreed profit sharing ratios between the bank and depositors. Under the framework, Bank Negara Malaysia allowed the IBIs to adopt either the weightage or without the weightage method, primarily to accord the system capacity of the IBIs.

The IBIs are required to calculate their rates of return on a monthly basis and to declare their monthly rates of return on a specified date. The following month would be the effective period of the declared rates of return.

The introduction of the framework has provided the IBIs with a standard approach in deriving the rates of return and has enhanced the level of transparency. The framework has also improved the efficiency level of the IBIs given that the rates of return are now reflective of the business acumen of the IBIs rather than the methodology of deriving the rates of return. The introduction of the PER has also reduced the volatility of the rates of return of the Islamic banking industry and enabled the IBIs to manage their portfolio more efficiently. In tandem with the introduction of the framework, the scope of the statistical submission has been broadened further to provide Bank Negara Malaysia with an effective measurement tool to assess the efficiency of the IBIs in terms of profitability, prudent management and fairness.

Bank Negara Malaysia has also undertaken a review of the framework in 2003 to promote capacity enhancement and efficiency among the IBIs in managing their business operations. While the foundation of the framework remained unchanged, the revised framework will provide, among others, flexibility in determining the weightage assigned to each group of deposits, the profit sharing ratio of investment deposits, the provisioning of PER and the segregation of income from the funds that are managed under a consolidated fund or managed separately between shareholders' and depositors' funds. The reviewed framework will provide greater flexibility to the IBIs in managing their portfolios and remain competitive in the market place.

Guidelines on the Specimen Reports and Financial Statements for Licensed Islamic Banks (GP8-i)

The Guidelines on the Specimen Reports and Financial Statements for Licensed Islamic Banks or GP8-i was issued to the Islamic banks (IBs) in August 2003. It sets out the minimum requirements for the presentation and disclosure of reports and financial statements of IBs. The GP8-i is to be adopted by the IBs for annual accounts commencing 2004.

The objective of the GP8-i is to provide the basis for presentation and disclosure of reports and financial statements of the IBs. GP8-i is also aimed at ensuring consistency and comparability of the reports and financial statements amongst the IBs in complying with the provisions of the Islamic Banking Act 1983, Companies Act 1965, Shariah requirements and other Bank Negara Malaysia guidelines. As a comprehensive guideline, GP8-i also incorporated the new requirements of MASB standards, specifically the MASB *i*-1: Presentation of Financial Statements of Islamic Financial Institutions. The standard, which came into effect in 2003, was issued to streamline the disclosure and presentation of financial statements of the IBs and the conventional banks that participate in the Islamic Banking Scheme (IBS banks).

Prior to the issuance of the GP8-i, the IBs observed the various provisions of the Companies Act 1965, the applicable accounting standards and the Guidelines on the Specimen Financial Statement for the Banking Industry (GP8) which was formulated to facilitate the conventional banking operations. Some of the requirements have been modified for the IBs, particularly those under the GP8, to reflect the Islamic banking operations such as the disclosure on the various Shariah concepts applied in financing.

Salient Features of GP8-i
The salient features of the GP8-i, amongst others, are as follows:

a) ***Performance Overview and Statement of Corporate Governance***
In promoting good corporate governance, IBs are required to report their performance overview and corporate governance practices. The performance overview requires the IBs to disclose their review on performance, measures, business plans and strategies, whilst the statement of corporate governance requires IBs, among others, to disclose the composition and responsibilities of the Board, internal audit and control activities and risk management strategies and policies. These report requirements are important in providing additional information to users in evaluating the performance and conduct of an IB.

b) ***Disclosure of Shariah Advisory Board/ Committee and Zakat Obligations***
The Shariah Advisory Board or Committee plays an important role in monitoring the compliance of Islamic banking activities with the Shariah requirements. Given its importance, the IBs are required to disclose the functions and duties of their Shariah Advisory Board or Committee in monitoring the activities pertaining to Shariah matters under the Directors' Report. With respect to the *zakat* obligations disclosure, IBs are required to disclose the responsibility towards payment of *zakat* either on the business or shareholders or on behalf of depositors.

c) ***Report of the Shariah Advisory Board/ Committee***
The IBs are required to report the conformity of the IB's operations with the Shariah principles under the Report of the Shariah Advisory Board/Committee. The Report, which is akin to the Auditors' Report, will enhance the credibility of the IB's operation in complying with the Shariah principles.

d) ***Profit Equalisation Reserves (PER)***
PER is a mechanism introduced in the Framework of the Rate of Return to stabilise the rate of return to depositors. Disclosure of PER would reflect the capability of the IBs in managing the level of profit distribution to the *mudharabah* depositors. The IBs are required to disclose their policy on PER as well as its movement (provision and write-back) during the financial year.

e) Classification of Deposits from Customers and Placements from Banks and Other Financial Institutions

The IBs are required to disclose their deposits into two categories i.e. *mudharabah* and non-*mudharabah* deposits. As the manager of public funds, the disclosure would provide additional information on the risk profile of the IBs' deposits portfolio to the public.

f) Presentation of the Income Statement

Presentation of the Income Statement of the IBs is structured to reflect the nature of the Islamic banking operation, mainly on the application of *mudharabah* concept in the deposit-taking activities. The statement discloses the incomes and expenses that are either shared by the bank and depositors or solely belonged to the bank.

Product Approval

- In tandem with the gradual progression towards a market-driven regulatory environment, Bank Negara Malaysia issued the Guidelines on New Product Approval Requirements for Islamic Banking Institutions (the Guidelines). These replace the existing product pre-approval requirements and came into effect on 2 January 2004. The Guidelines outline the notification and specific approval process for new products submitted by Islamic banking institutions.

  In formulating the Guidelines, Bank Negara Malaysia adopted the approach that "what is not prohibited is allowed" on new Islamic banking products. This was to provide greater clarity, transparency and speedy product approval. For a new product to qualify for automatic approval (under notification process), the submission to Bank Negara Malaysia must be made at least 21 days before its launch date. The definition of a new product has also been widened to include an existing approved product or service that is applying a different or a new combination of Shariah concepts. In addition, the Islamic banking institutions are required to submit a detailed explanation on the Shariah concepts used in the product as endorsed by their Shariah committee. This is to ensure that a thorough research on the product has been carried out by the Islamic banking institutions and thus, would not lead to any detrimental effect on the customers and on the stability of the financial system. A new product that does not qualify for automatic approval would require specific approval from Bank Negara Malaysia and may require, among others, the deliberation of the Shariah Advisory Council of Bank Negara Malaysia. The Guidelines place significant emphasis on self-regulation, where the Islamic banking institutions are required to ensure consistency of the products introduced with the Guidelines.

- In line with efforts to streamline the regulatory framework of the credit card industry, Bank Negara Malaysia issued the Credit Card-i Guideline (the Guideline) in January 2004. This was an extension to the Credit Card Guideline issued to the conventional banks in March 2003. Under the Guideline, the credit card-i can apply either *bai' inah* (sell and buy back arrangement) or BBA (deferred payment sale) Shariah concept. Under the *bai' inah* concept, the fund for the cardholder's spending limit is created upon the bank buying back the asset from the cardholder for cash which it previously sold to the cardholder on deferred terms. Under the BBA concept, the fund is created upon the bank purchasing the asset from the cardholder for cash which will be sold back to the cardholder on deferred basis.

  The Guideline also prescribes the treatment on penalty and fee structure according to the Shariah principles. In terms of late payment charges, issuers of credit card-i are allowed to impose a compensation fee on the defaulters subject to specific terms and conditions imposed by Bank Negara Malaysia. The terms and conditions, among others, prohibit the Islamic banking institutions from compounding the compensation fee for late payment and monthly charges. This provision was intended to protect the customers as well as to streamline the penalty structure of credit card-i.

Strengthening Shariah and Legal Infrastructure

One of the pre-requisites for a strong and stable Islamic banking system is the existence of a

comprehensive Shariah and legal infrastructure. A strong Shariah framework combined with a sound legal structure would accelerate the pace of development and innovation of the Islamic banking industry.

- As part of the efforts to strengthen the Shariah framework for the Islamic financial industry, Bank Negara Malaysia amended the Central Bank of Malaysia Act 1958 (CBA) in 2003 to position the Shariah Advisory Council (SAC) of Bank Negara Malaysia as the sole authority on Shariah matters pertaining to Islamic banking and finance that fall under the purview of Bank Negara Malaysia. With that stature, the SAC will serve as the reference point for the court or arbitrator in dispute resolution that involves Shariah issues on Islamic banking and finance cases.

- Consequent to this development, the role of the Shariah advisory bodies and Shariah consultants at the Islamic banks, the IBS banks and takaful companies will be rationalised accordingly. Bank Negara Malaysia is preparing a comprehensive guideline on the new structure, roles and functions of the Shariah committees of the Islamic banks, the IBS banks and the takaful operators. The guideline would specify among others, the requirements for the appointment of the Shariah committee members. In this regard, the Islamic financial institutions are required to seek Bank Negara Malaysia's approval prior to the appointment of the Shariah committee members. The duties and responsibilities of the Islamic financial institutions would also be outlined in order to assist the Shariah committee in carrying out its roles and functions effectively. The guideline is expected to be issued in the first quarter of 2004.

- A significant development in respect of legal infrastructure was the establishment of a dedicated High Court to adjudicate all muamalat cases in the Commercial Division of High Court Kuala Lumpur. In this regard, a directive (Practice Direction No. 1 of 2003) was issued by the Chief Judge Malaya to all legal practitioners in the country to register Islamic banking and finance cases at both the High Courts and the lower courts using a special code number. The establishment of the dedicated High Court for Islamic banking and finance will expedite the hearing of Islamic banking and finance cases and further increase public confidence in Islamic banking and finance.

- To complement the court system, Bank Negara Malaysia has identified arbitration as an alternative dispute resolution mechanism for Islamic banking and finance. Arbitration has been acknowledged as an appropriate dispute resolution mechanism especially for high-scale financing facilities to reduce the court process which can be time consuming. Towards this end, Bank Negara Malaysia is finalising an arrangement with an existing institutional arbitration centre to administer Islamic banking and finance arbitration.

- The Financial Mediation Bureau (FMB) has been established as a single mediation centre for both banking and insurance, including Islamic banking and takaful. This Bureau replaces existing bureaus for the banking and insurance industry. The FMB is expected to provide speedy and cost-effective mediation for consumers to redress complaints on products and services offered by the financial institutions.

- In addition to the dispute resolution mechanism, there is also a need to create a conducive legal environment to cater for the unique nature of transactions in Islamic banking and finance. Bank Negara Malaysia has formed the Law Review Committee in June 2003, comprising representatives from the Attorney General's Chambers, Ministry of Finance, Malaysian Bar Council, industry players and legal practitioners. The Committee will review the existing laws and make recommendations to the relevant authorities to enable smooth execution of Islamic banking and financial contracts. The review covers tax and stamp duty laws, company laws, land laws and procedural laws.

Enhancing Intellectual Capital Development and Consumer Education

The creation of a large pool of talented bankers is critical for the development of a dynamic and competitive Islamic banking industry.

- To achieve this objective, Islamic Banking and Finance Institute Malaysia (IBFIM) has been earmarked to spearhead efforts to create the pool of bankers who are both knowledgeable and competent in Islamic banking and finance. In this respect, IBFIM will focus on enhancing its capacity in three key areas encompassing education and training, consultancy and advisory as well as research and publications.

- As part of the objective to elevate consumer education and awareness in Islamic banking and finance, the Association of Islamic Banking Institutions Malaysia, under the auspices of Bank Negara Malaysia, organised the Islamic Banking and Takaful Week (IBTW 2003) from 26 September to 2 October 2003. Activities organised during the week included a three-day exposition on Islamic banking and finance.

- In conjunction with the IBTW 2003, Bank Negara Malaysia, together with participating Islamic financial institutions, jointly hosted the production of a television documentary programme on Islamic banking and finance, entitled "Kewangan Islam" (Islamic Finance). The 11-episode documentary programme, produced by a local broadcasting station, portrayed the development of the Islamic financial system in Malaysia as well as products and services offered by the Islamic financial institutions.

  To further increase public literacy in Islamic banking and finance, information booklets were published on "What is Islamic Banking?" and "House Financing-i" as part of the Consumer Education Programme through "BankingInfo". The booklets provide consumers with basic knowledge and understanding on Islamic banking, the underlying Shariah principles and concepts, the range of Islamic banking products and services as well as information on the mechanics of house financing based on Shariah principles.

PERFORMANCE OF THE ISLAMIC BANKING SYSTEM

The Islamic banking industry continued to register strong expansion during the year with increasing market share in terms of assets, financing and deposits of the total banking system. The improved performance was characterised by strong capitalisation levels attributable to increases in capital and profits as well as higher financing activities with significant growth in financing for the purchase of transport vehicles and residential property. In addition, asset quality recorded further improvement with a declining trend in net non-performing financing ratio and high financing loss provisions.

Capital Strength

The total capital base of the Islamic banking institutions increased from RM5.1 billion as at end-2002 to RM6.8 billion as at end-2003. New capital injections contributed RM1 billion to the increase in capital base in 2003 whilst the audited profits contributed another RM414.6 million. The new capital injections were due to the participation of a merchant bank in the IBS and the maintenance of adequate capital by IBS banking institutions.

Table 5.2
Islamic Banking System: Sources and Uses of Funds

	Annual change		As at end 2003*p*
	2002	2003*p*	
	RM million		
Sources			
Capital and reserves	1,269	2,081	6,784
Deposits	6,200	6,906	60,212
Funds from other financial institutions	271	2,541	6,985
Other liabilities	1,401	2,598	8,215
Total	**9,141**	**14,126**	**82,196**
Uses			
Cash	39	15	255
Reserve with Bank Negara Malaysia	318	321	1,517
Deposits with other financial institutions	-3,767	1,247	8,982
Financing	8,517	11,897	48,615
Securities	4,014	3,277	22,554
Other assets	20	-2,631	273

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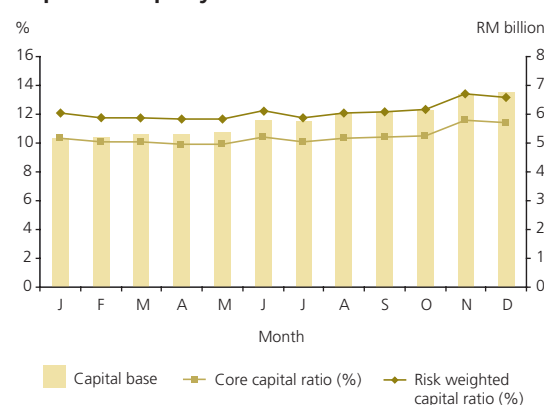
In tandem with the new capital injection, total tier-1 capital increased by RM1.4 billion or 31.1% to RM5.9 billion, while total tier-2 capital recorded an increase of RM215.9 million following an increase in general provision for bad and doubtful financing. As at end-2003, the Islamic banking system recorded a strong risk-weighted capital ratio (RWCR) of 13.1% and core capital ratio of 11.4%.

Graph 5.1
Islamic Banking System: Capital Adequacy in 2003

The RWCR of Islamic banks and IBS commercial banks stood at 11.8% and 14.3% respectively. The RWCR of the IBS merchant banks as a group increased from 10.9% to 13.5% due to the increase in the Islamic banking fund by two merchant banks amounting to RM80 million as well as the participation of an additional merchant bank in the Islamic Banking Scheme. As for the IBS finance companies, the capital base increased by 33.2% or RM479 million to RM1.9 billion during 2003. Meanwhile, the risk-weighted assets expanded by 47.9% or RM4.9 billion to RM15.1 billion, mainly from hire purchase financing, which resulted in a marginal decline in the RWCR by 1.4 percentage point to 12.7%.

Total risk-weighted assets of the Islamic banking system grew by 24.4% or RM10.1 billion to RM51.5 billion as at end-2003. The increase was seen across the risk categories except for the 10% category where there was reduction in interbank placements with discount houses and Cagamas *mudharabah* bonds held. A large increase was recorded in the 100% and 50% risk categories (RM8.3 billion and RM2.9 billion respectively) due to other financing and end-financing of residential properties.

Reflective of the strong capital position of the Islamic banking system in 2003, the RWCR and core capital ratio of the system remained consistently above 11% and 9% respectively throughout the year.

Assets

As at end-2003, the total assets of the Islamic banking sector increased by RM14.1 billion or 20.8% to RM82.2 billion. A significant portion of the increase in total assets was attributable to the growth in total financing of IBS commercial banks (33.6%) and IBS finance companies (56.7%), constituting 78.3% of total financing. As in previous years, a notable trend observed during the year was the shift of funds from interbank deposits to investment in securities to secure a higher rate of return. Investment in securities of RM22.6 billion accounted for 27.4% of total assets and marked an increase by RM3.3 billion or 17% during the year. In terms of market share, the largest portion of Islamic banking assets remained with the IBS commercial banks with a share of 44.8%, followed by Islamic banks (25.5%) and the IBS finance companies (21.8%). In terms of the growth in assets, IBS finance companies recorded the highest growth of 41.6%, followed by IBS commercial banks (26.5%) and merchant banks (20%).

Financing Activities

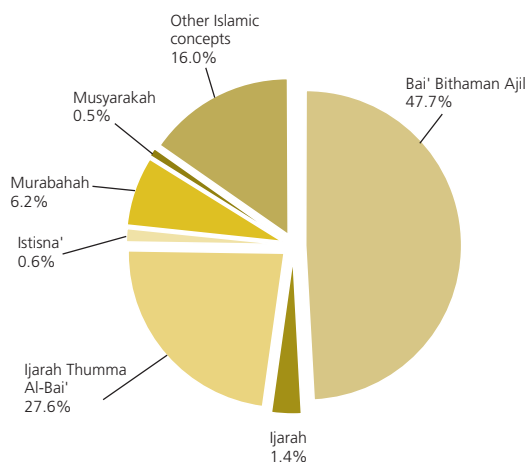
Total financing extended by the Islamic banking system expanded by 32.4% or RM11.9 billion (2002: 30.2% or RM8.5 billion). The growth in financing was largely attributable to the significant growth in the financing for the purchase of passenger vehicles and residential property of 60.8% and 33.3% respectively. The higher consumer demand was further expanded by the attractive and competitive financing packages offered by the Islamic banking institutions. Financing based on *bai' bithaman ajil* (deferred payment sale) concept remained dominant, constituting 47.7% of total financing while *ijarah thumma al-bai'* (hire purchase) constituted 27.6%.

Against the backdrop of strong demand from consumer spending and corporate financing, the value of financing applications received by the Islamic banking institutions in 2003 increased by 8.8% to RM26.3 billion. Responding to the strong demand for new financing, RM16.7 billion of new financing was approved during the year, whilst disbursements posted a growth of 49.5%. Meanwhile, financing

Table 5.3
Islamic Banking System: Direction of Financing

	Annual change		As at end 2003*p*
	2002	2003*p*	
	RM million		
Agriculture, hunting, forestry and fishing	-45.6	267.6	1,861.6
Mining and quarrying	10.5	-11.0	63.5
Manufacturing	807.8	505.6	4,386.8
Electricity, gas and water	-9.9	-284.8	248.9
Community, social and personal services	-139.2	89.4	303.3
Broad property sector	4,953.2	4,747.0	20,482.7
Real estate	*103.5*	*142.6*	*811.9*
Construction	*579.9*	*655.3*	*2,933.5*
Purchase of residential property	*3,916.9*	*3,581.4*	*14,344.2*
Purchase of non-residential property	*353.0*	*367.7*	*2,393.1*
Wholesale and retail trade, restaurants and hotels	251.2	410.6	1,797.0
Transport, storage and communication	61.8	199.5	1,024.3
Finance, insurance and business services	42.2	661.6	1,933.3
Purchase of securities	62.4	-14.1	920.9
Consumption credit	2,474.5	5,584.9	14,872.1
Credit cards	*57.5*	*95.7*	*156.2*
Personal uses	*374.7*	*575.5*	*1,637.1*
Purchase of consumer durables	*8.1*	*-9.2*	*54.1*
Purchase of transport vehicles	*2,034.1*	*4,922.9*	*13,024.7*
Others	47.5	-258.7	720.9
Total	**8,516.4**	**11,897.6**	**48,615.3**

p Preliminary

Graph 5.2
Islamic Banking System: Financing Concepts as at end-2003

repayments increased by 26.3% during the year. On average, RM3 billion of financing were disbursed monthly in 2003, compared with RM2 billion in 2002. Given the favourable economic outlook, strong capital position and ample liquidity in the Islamic banking system, the Islamic banking institutions are well positioned to sustain the growth momentum in financing activities in 2004.

Given the favourable economic outlook, strong capital position and ample liquidity in the Islamic banking system, the Islamic banking institutions are well positioned to sustain the growth momentum in financing activities in 2004.

The Islamic banking sector also focused on providing financing to small and medium-sized enterprises (SMEs). The total financing provided by the Islamic banking institutions to the SMEs increased by 77.1% from RM3.5 billion as at end-2002 to RM6.2 billion as at end-2003. Islamic financing contributed 7.5% of the total financing extended by the banking system to the SMEs as at end-2003 as compared to 4.7% as at end-2002.

Asset Quality

The asset quality of the Islamic banking industry continued to improve during the year. As at end-December 2003, the gross and net NPF ratios stood at 8.6% (2002: 8.9%) and 5.5% (2002: 5.7%) respectively based on a 6-month classification. The net NPF ratio of the Islamic banking institutions was sustained within the range of 5.3% to 5.6% throughout the year. Financing loss coverage remained high at 53.7% of total NPF as at end-December 2003. In terms of absolute amount, financing loss coverage increased to RM2.4 billion from RM2 billion in 2002. The income-in-suspense, general provision and specific provision set aside by Islamic banking institutions increased by 43.7%, 33.7% and 3.9% respectively during the year. Overall, the average general provision for Islamic banking industry stood at 1.9% of total net financing reflecting the prudent stance of a number of Islamic banking institutions in setting aside higher provisions for financing. This was further reinforced through the separate apportionment of general provision for the Islamic banking financing portfolio of IBS banks following the introduction of the standard framework for the calculation of the rate of return.

Table 5.4
Islamic Banking System: Financing Activities

	For the year		Annual change (%)
	2002	2003*p*	
	RM million		
Financing approvals	12,310	16,739	36.0
Financing disbursements	24,187	36,162	49.5
Financing repayments	20,776	26,241	26.3
	As at end		Annual change (%)
	2002	2003*p*	
	RM million		
Outstanding financing	36,718	48,615	32.4

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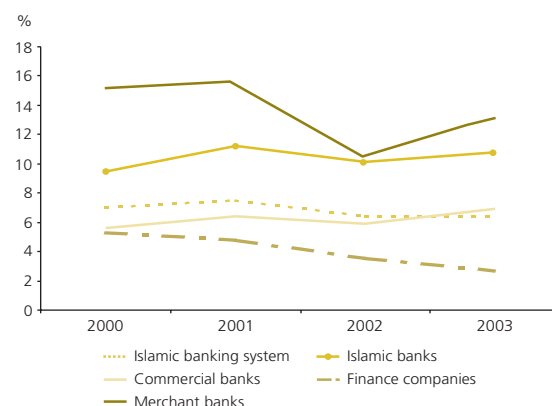
Graph 5.3
Islamic Banking System: Net Non-performing Financing Ratio[1]

[1] Based on actual classification

Table 5.5
Islamic Banking System: Non-performing Financing and Financing Loss Provisions

	As at end					
	2002			2003*p*		
	Actual[1]	Classification		Actual[1]	Classification	
		3-month	6-month		3-month	6-month
	RM million					
Islamic banks						
General provisions	209.1	209.1	209.1	170.5	170.5	170.5
Income-in-suspense	133.2	142.2	133.2	178.2	186.9	178.2
Specific provisions	395.4	436.4	395.4	406.7	434.9	406.7
Non-performing financing	1,396.4	1,933.0	1,396.4	1,575.5	2,002.2	1,575.5
Net NPF ratio (%)[3]	10.1	15.8	10.1	10.8	15.1	10.8
Total provisions/ NPF (%)	52.8	40.8	52.8	47.9	39.6	47.9
Commercial banks[2]						
General provisions	250.0	226.5	247.9	400.9	379.7	300.8
Income-in-suspense	113.0	78.1	111.4	213.3	130.1	207.1
Specific provisions	222.4	222.4	222.3	280.3	284.4	309.3
Non-performing financing	1,300.0	1,604.2	1,085.0	1,991.7	2,274.4	1,653.7
Net NPF ratio (%)[3]	5.9	7.9	4.6	6.9	8.5	5.2
Total provisions/ NPF (%)	45.0	32.9	53.6	44.9	34.9	49.4
Finance companies[2]						
General provisions	202.2	202.2	202.2	316.7	316.6	318.7
Income-in-suspense	129.8	158.7	126.3	150.8	155.8	149.8
Specific provisions	279.4	748.9	238.3	274.9	296.7	274.5
Non-performing financing	751.5	919.0	671.1	832.3	1,058.7	805.1
Net NPF ratio (%)[3]	3.6	0.1	3.2	2.7	4.0	2.5
Total provisions/ NPF (%)	81.4	120.8	84.5	89.2	72.6	92.3
Merchant banks[2]						
General provisions	12.2	12.2	12.2	12.1	12.1	12.1
Income-in-suspense	15.6	15.6	15.6	20.6	20.7	20.6
Specific provisions	33.6	33.6	33.6	5.4	5.4	5.4
Non-performing financing	127.7	127.7	127.7	125.6	128.3	125.6
Net NPF ratio (%)[3]	10.4	10.4	10.4	13.2	13.5	13.2
Total provisions/ NPF (%)	48.1	48.1	48.1	30.3	29.8	30.3
Islamic banking system						
General provisions	673.5	649.9	671.3	900.2	879.0	802.0
Income-in-suspense	391.7	394.6	386.6	562.9	493.5	555.6
Specific provisions	930.7	1,441.3	889.6	967.2	1,021.4	995.8
Non-performing financing	3,575.5	4,583.9	3,280.2	4,525.1	5,463.6	4,159.9
Net NPF ratio (%)[3]	6.4	7.9	5.7	6.4	8.4	5.5
Total provisions/ NPF (%)	55.8	54.2	59.4	53.7	43.8	56.6

[1] Financing classified as NPF based on individual banking institution's NPF classification policy i.e. 3-month or 6-month classification.
[2] Refers to Islamic banking portfolio of conventional banking institutions participating in Islamic Banking Scheme and represents a subset of the figures reported under the total banking system for commercial banks, merchant banks and finance companies.
[3] Net NPF ratio = (NPF less IIS less SP) / (Gross financing less IIS less SP) x 100%.
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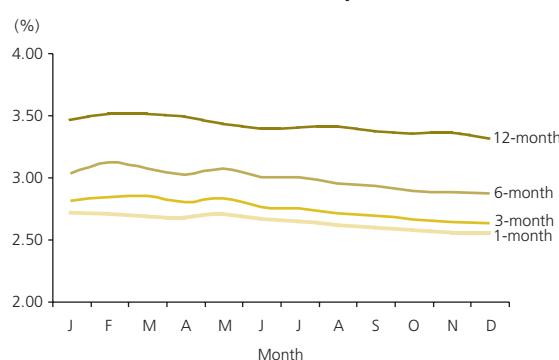
The broad property sector continued to account for the largest share, at 62.3% of the total NPF (2002: 59.7%). The high NPF in the broad property sector reflected the increase of NPF in the residential property and construction sectors of RM451 million and RM174.5 million respectively. In addition, there was also an increase in NPF in transport, storage and communication sector of RM108.2 million.

Rates of Return

The rates of return on investment deposits were influenced by the asset yield, asset quality and the level of total deposits of the Islamic banking institutions. During the year, in tandem with favourable financing growth and asset quality, the rates of return to the investment account depositors recorded stable

Graph 5.4
Islamic Banking System:
Trend of Rate of Return to Depositors

movement across the different tenures. The rates for 1-month and 3-month ranged between 2.56% to 2.72% and 2.63% to 2.85% respectively. The stable movement was also influenced by the changes made to the profit sharing ratio of each deposit tenure and the existence of the Profit Equalisation Reserve that enabled Islamic banking institutions to manage the volatility of the rates.

Profitability

In line with the moderate growth in total financing, the Islamic banking sector recorded an increase in net finance income of RM555 million at the operating level. Notably, the non-finance income of the Islamic banking sector registered an increase of RM232 million or 46.9%. The Islamic banking sector posted higher profit before provision that amounted to RM2.3 billion (2002: RM1.7 billion). After allocating financing loss provisions, the Islamic banking sector recorded profit before tax for the calendar year 2003 that amounted to RM977.2 million (2002: RM947.8 million). Despite the increase in provisions that amounted to RM1.3 billion, a higher profit before tax was recorded as the increase in finance and non-finance income more than offset the increase in provisions. The higher financing loss provisions charged by the Islamic banking institutions were partly due to the increase in NPF and Profit Equalisation Reserve.

Liquidity

There was ample liquidity in the Islamic banking system throughout 2003. Total deposits recorded a moderate growth of 13% or RM6.9 billion to reach RM60.2 billion as at end-2003. The IBS commercial banks and the Islamic banks accounted for the major share (73.2%) of total deposits in the Islamic banking sector (2002: 74.8%). The IBS merchant banks recorded the highest growth rate in deposits (24.6%) followed by the IBS finance companies (20.6%).

Investment deposits (general and special) continued to capture a major portion of the deposits, accounting for 58.5% of the total. During the year, savings and demand deposits grew by 26.6% and 19.6% respectively mainly due to the increase in the retail customer base. In terms of the maturity profile of general investment deposits, 52.6% of the general investment deposits continued to be concentrated at the shorter end of the spectrum, mainly in the one- to three-month tenure as the incremental return between the shorter and longer placement tenures remained small. The average deposit rates remained stable in year 2003.

In terms of liquidity position, the two Islamic banks had sufficient liquidity to meet any unexpected withdrawals for a period of up to one month. This represented surplus liquidity above the minimum requirement of 3% and 5% for the up-to one-week and one-week to one-month time buckets respectively. The financing-to-deposits (FD) ratio of

Table 5.6
Islamic Banking System: Income and Expenditure

	For the calendar year		Annual change	
	2002	2003*p*	2003*p*	
	RM million		RM million	%
Finance income net of income-in-suspense	3,196	3,870	674	21.1
(Income-in-suspense)	*373*	*306*	*-67*	*-18.0*
Less: Finance expense	1,569	1,688	119	7.6
Net finance income	1,627	2,182	555	34.1
Add: Non-finance income	495	727	232	46.9
Less: Staff cost	199	229	30	15.1
Overheads	269	384	115	42.8
Profit before provisions	1,654	2,296	642	38.8
Less: Financing loss & other provisions	706	1,319	613	86.8
Pre-tax profit	948	977	29	3.1
Return on assets (%)	1.4	1.2		
Return on equity (%)	20.2	14.4		

p Preliminary

Table 5.7
Islamic Banking System:
Deposits by Type and Institution

	Annual change				As at end 2003*p*
	2002		2003*p*		
	RM million	%	RM million	%	RM million
Demand deposits	**2,727**	**42.2**	**1,796**	**19.6**	**10,980**
Islamic banks	834	31.9	693	20.1	4,143
Commercial banks	1,893	49.3	1,103	19.2	6,837
Savings deposits	**1,275**	**30.7**	**1,442**	**26.6**	**6,866**
Islamic banks	308	21.2	190	10.8	1,952
Commercial banks	897	42.1	1,145	37.8	4,175
Finance companies	70	12.5	107	16.9	739
Investment deposits	**2,463**	**7.4**	**-741**	**-2.1**	**35,227**
Islamic banks	909	8.9	93	0.8	11,183
Commercial banks	-1,032	-7.6	-2,351	-18.7	10,227
Finance companies	1,419	20.3	614	7.3	9,019
Merchant banks	7	1.9	213	56.5	590
Discount houses	1,160	49.2	690	19.6	4,208
Other deposits	**-266**	**-8.9**	**4,410**	**161.6**	**7,139**
Islamic banks	-5	-4.0	187	157.1	306
Commercial banks	-314	-12.8	3,148	147.6	5,281
Finance companies	-59	-50.9	1,150	2,017.5	1,207
Merchant banks	4	1.3	-46	-15.0	261
Discount houses	108	2,160.0	-29	-25.7	84

p Preliminary

the Islamic banking institutions has shown a favourable trend. The FD ratio increased from 68.9% as at 31 December 2002 to 80.7% as at end-2003 due to the more rapid increase in the total financing base compared with deposits during the period.

Islamic Interbank Money Market (IMM)

During the year, liquidity in the IMM was ample. The excess liquidity, however, was maintained at an appropriate level following a series of liquidity operations undertaken by Bank Negara Malaysia. Apart from using *wadiah* interbank deposits to absorb liquidity, the RM2 billion worth of Government Investment Issues (GIIs) and RM1 billion in Bank Negara Negotiable Notes (BNNNs) were issued, which helped stabilise liquidity conditions. The active management of the surplus liquidity position through the issuance of government and Bank Negara Islamic papers has correspondingly reduced the amount of funds absorbed by Bank Negara Malaysia through direct acceptance of *wadiah* interbank deposits. The average daily amount outstanding absorbed through *wadiah* interbank deposits declined by 61.3% from RM6.2 billion in 2002 to RM2.4 billion in 2003.

The increase in the supply of GII and BNNN contributed significantly to higher trading in these instruments. Trading in GIIs recorded an increase of 511.9% (RM30.2 billion) and in BNNNs recorded an increase of 300% (RM6.6 billion). The increase in the supply of Government papers has promoted active secondary market trading in the IMM. In addition, Bank Negara Malaysia also introduced a new measure whereby principal dealers are required to perform the role of market makers for GIIs and BNNNs. This measure has put in place the price discovery process to facilitate trading in the primary and secondary market.

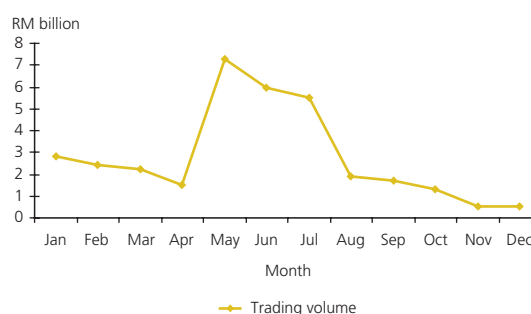
Trading in interbank deposits and other instruments such as trade bills in the IMM also registered positive growth. During the year, the *mudharabah* interbank investments recorded a moderate increase of 14.9% totalling to RM283.8 billion (2002: RM247 billion). Trading of Negotiable Islamic Debt Certificates (NIDCs) also registered a positive growth. Islamic banking institutions have intensified the issuance of Islamic negotiable instruments of deposit to mobilise longer-term deposits (a maturity tenure of more than 6 months) by issuing NIDCs. This initiative spurred active trading of NIDC in the IMM, which recorded a triple-digit growth of 425%. However, in absolute terms, the trading of NIDC remained relatively small. The trading of short-term trade bills also showed an encouraging growth of 40.3%, from RM24.8 billion in 2002 to RM34.8 billion in 2003, emanating from the increase in trade financing activities.

During 2003, the trading of Islamic private debt securities (IPDS) increased by 59.7% to RM60.7 billion from RM38 billion in 2002. This higher increase emanated from new issues of IPDS amounting to RM8.1 billion, and strong trading sentiments in the first half of the year. The year 2003 also witnessed the issue of the first asset-backed securities that were structured on Islamic principles amounting to RM986 million.

Table 5.8
Islamic Interbank Money Market

	2002	2003*p*	Annual change	
	RM billion		RM billion	%
Islamic Funds				
Mudharabah Interbank Investments*	247.0	283.8	36.8	14.9
Islamic Papers				
Government Investment Issues	5.9	36.1	30.2	511.9
Bank Negara Negotiable Notes*	2.2	8.8	6.6	300.0
Short-term Trade Bills*	24.8	34.8	10.0	40.3
Negotiable Islamic Debt Certificates*	0.8	4.2	3.4	425.0
Total	**280.7**	**367.7**	**87.0**	**31.0**

* Volume transacted through brokers.
p Preliminary

Graph 5.5
GII - Trading Volume

Graph 5.6
GII - Average Yield to Maturity